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# WHY WAR WOULD BE JUSTIFIED

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# Fixing the finances

There is no way round painful reforms to make Brazil's debts sustainable and speed up growth

FOR the past year the pundits have been arguing over whether Brazil is bound to follow Argentina into default. Even after the IMF stepped in with a \$30 billion loan last August, some remained convinced that Brazil's public-debt burden, which almost doubled during Mr Cardoso's presidency, to 56% of GDP, had become unsustainable, and that sooner or later the country would have to "restructure", willingly or otherwise. Others maintained that the country's twin deficits were well under control, with the government consistently running primary surpluses (before interest payments) and the current-account gap shrinking, thanks to a plunge in the *real*, all of which made a default seem a lot less likely.

John Williamson of the Institute for International Economics in Washington, DC, was one of several economists to crunch the numbers and conclude that a default by Brazil is neither inevitable nor impossible, but will depend largely on investors' expectations. Since most public debt is linked either to short-term interest rates or to the *real*'s exchange rate, Mr Williamson reckoned that, unless these recovered, the debt burden would continue to rise. Investors would take fright and the *real* would plunge further. Attempts to shore it up by pushing interest rates even higher would merely hasten the end.

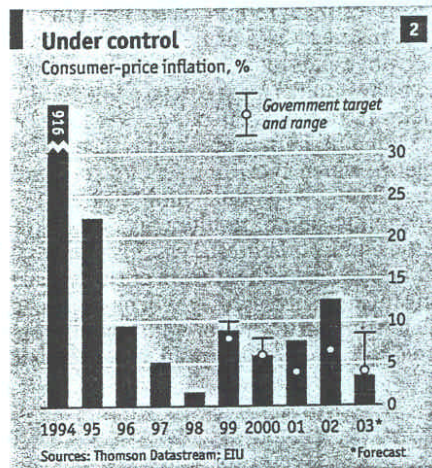
The no-default camp says there is a way out of this. Most of the public debt is denominated in *reais* (including some that is dollar-indexed but pays out in local currency), so in a tight spot the government could just print more *reais* to repay any debt it could not roll over. The trouble is that this would crank up inflation, which disproportionately hurts the poorest. Would Brazil's first left-wing president really rather default on the poor than on the rich investors in government bonds?

Even if he did, printing money to keep repaying the domestic debt might not avoid financial collapse. The government's foreign-currency-denominated debt, although a minority of the total, is significant, amounting to about \$82 billion of the public debt of \$250 billion, and Brazilian firms have foreign-currency debts of about \$96 billion. Brazil as a whole is al-

ready using 91% of its export earnings to service its foreign debt. If foreign banks called in their credit lines, Brazil would soon run out of foreign currency to keep servicing its overseas debt and thus go bust by another means. That is why, when Antônio Palocci was chosen as Lula's finance minister, he went straight off to America to beg the big banks to keep their credit lines open.

However, if investors become convinced that the government has got its finances under control, the *real* will recover and interest rates will fall, making the cost of servicing the debt more bearable. Lower interest rates, and an increased willingness by both foreign and domestic banks to lend, would boost the economy. An improved domestic outlook would encourage multinationals to restart their stalled investment programmes in Brazil, further boosting growth. Since the debt-GDP ratio depends on the trajectory of GDP as well as that of the debt, any boost to growth would bring a further improvement in Brazil's debt ratio which would reassure investors. All the government has to do is persuade investors that everything is going to be fine, and it will be. Lula, literally, has to pull off a confidence trick.

In an attempt to convince investors that its conversion to fiscal rectitude is genuine, the government this month announced a rise in its target for the primary surplus (ie, before debt service) from 3.75% to 4.25% of GDP. The most obvious way for a left-wing government to achieve the new target

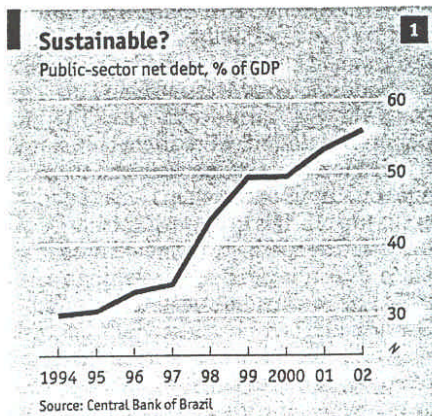


might be to raise taxes, but taxation in Brazil is already high: 36% of GDP, higher than in America. Raising it further could be counterproductive, because it would encourage even more evasion than now, and perhaps even reduce revenue rather than increase it.

## The hard reality

The alternative is spending cuts—not a welcome idea when you have just been elected on a manifesto chock-full of expensive promises to reduce poverty, improve health, education and housing, invest more in infrastructure and provide more credit to boost growth. However, in the very short term it may be the only option. To scrape together money for his flagship social project, *Fome Zero* (Zero Hunger, an ambitious plan to give all poor Brazilians three square meals a day), Lula was forced, immediately on taking office last month, to delay (or possibly cancel) plans to renew the air force's ancient fleet of fighter jets and to mothball some big road-building projects.

Lula's predecessor, Mr Cardoso, found he had to keep inventing new taxes and to hack away at capital spending. But these measures seemed to make Brazil no less vulnerable to market panics; instead, they hobbled the economy's growth potential (for instance, in 2001 electricity had to be rationed). One reason was that Mr Cardoso had started owning up to the public



► sector's huge hidden liabilities, mostly resulting from previous governments' reckless policies. Just one such liability, resulting from a state bank's subsidy to home buyers, created in 1967, will cost 63 billion *reais*. In all, the "skeletons" (as they are known) cleared from the government's closets so far have added about 10% of GDP to the public debt. But there are still plenty more rattling around—worth, by some guesses, another 10% of GDP.

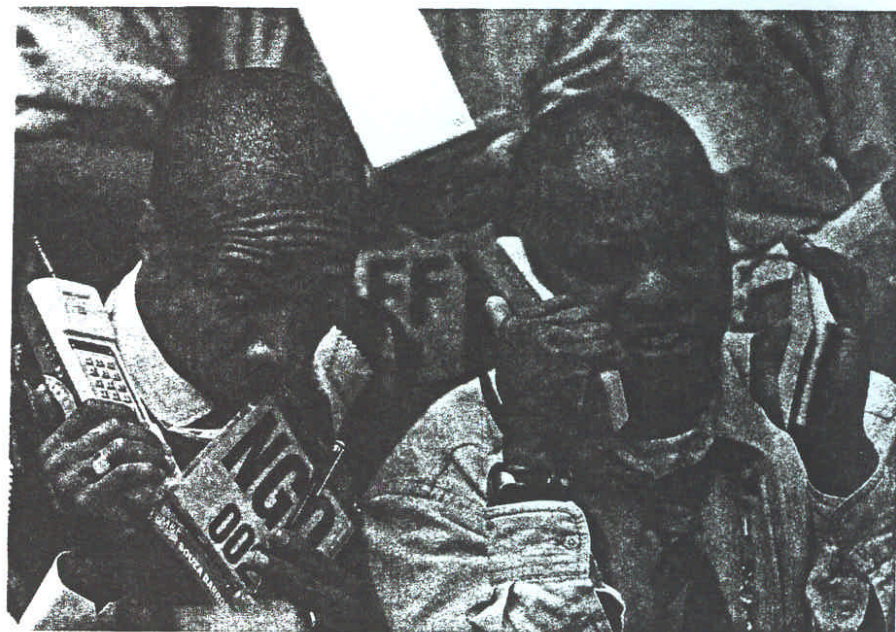
The way out for Lula is to push ahead with the fundamental reforms that Mr Cardoso left unfinished. Together these could allow him to target the government's resources more effectively and to raise the economy's underlying growth potential, as well as increasing tax revenues.

### Off target

When the time comes, very soon, for Lula to take on vested interests (including those who elected him) to push through deep reforms, he should draw inspiration from a rough calculation by Marcelo Neri, an economist at the *Getulio Vargas Foundation*, a university. He says that about 50m Brazilians earn less than the 79 *reais* a month reckoned to be needed to eat properly. Bringing the income of each and every one of them up to this bare minimum would cost 20 billion *reais* a year. It sounds a lot, but it is only one-twelfth of Brazil's current social spending of 240 billion *reais*. The problem is not that the government itself is too poor to tackle poverty, but that so little social spending reaches those who most need it.

Mr Cardoso's government made a start on changing this (see next article), but much more remains to be done. As Mr Palocci said in his inaugural speech as finance minister, "The state spends a lot, and badly." During Mr Cardoso's term of office, real public spending, excluding debt service, increased by an impressive 6% a year (though Lula and his friends, then in opposition, constantly moaned about the Cardoso administration's "cuts").

So where does all this money go? The biggest destination for social spending is pensions. For some groups, such as the millions of poor rural workers granted modest retirement benefits in the early 1990s, the pensions system is genuinely redistributive. But most pension spending is on people who are not poor and not necessarily old. This is especially true of the various pension schemes for public-sector workers at federal, state and municipal levels. These pay out 100% of final salary (whereas schemes in rich countries typi-



Oh no, not more skeletons in the cupboard

cally pay only 50-75%) and allow workers to retire unreasonably early, often in their 50s, sometimes to take another public-sector job that will entitle them to a second generous pension.

Mr Cardoso tried to change this repeatedly, but only partly succeeded. He did manage to introduce a new "taper" for the pension scheme for private-sector workers that reduced benefits for those retiring early; but when he attempted to cut retired public servants' benefits, the Supreme Court ruled the legislation to be unconstitutional. The drastic fall in the birth rate since the 1960s (when Brazilian women had an average of 6.3 children each, compared with 2.3 now), together with rapidly rising life expectancy, means that the contributions of today's workers will have to support ever-rising numbers of pension-

ers. The government says the combined deficit of all the pension schemes for private- and public-sector workers is now above 5% of GDP and rising, though critics reckon that this exaggerates the problem: after all, the government, like other employers, should expect to make contributions to its workers' pension schemes.

### Crunch time

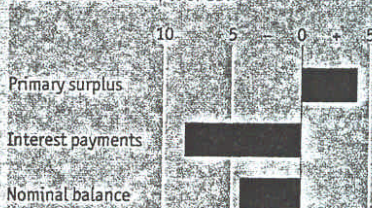
Chile defused its pensions time-bomb by transferring workers into new, privately run pension funds, with the government borrowing money to endow these funds with assets. But Brazil is too heavily indebted already to be able to try this. And a gentle transition, in which new and less generous pension rules apply only to new recruits, will not be enough to stop the deficit growing. Existing entitlements will have to be cut, or pension contributions increased—or preferably both.

When in opposition, Lula and the PT opposed Mr Cardoso's attempts to sort out pensions. Now, in power, they have done an about-face and are promising to submit bold reforms to Congress by the middle of this year. Ricardo Berzoini, the new pensions minister, has talked of capping public servants' pensions—which can be more than ten times the current ceiling for private-sector pensioners of a mere 1,561 *reais*. So far, the signs are not promising: under pressure from military bosses, Lula has already agreed to exempt the armed forces from this reform. The largest trade-union confederation, outraged that those with the most egregiously generous pensions of all might escape cuts, is threatening a general strike if those privileges are preserved.

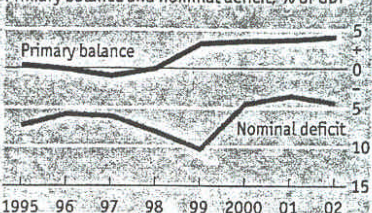
The World Bank has put forward various other proposals to cut the pension deficit for Brazil's public service. These in-

### A surplus of sorts

Fiscal balance, 2002, % of GDP\*



Primary balance and nominal deficit, % of GDP\*



Source: Central Bank of Brazil

\*Inflation-adjusted

clude raising the contributions being paid by current staff, and reviving Mr Cardoso's plan to cut existing pensions by the round-about route of making retired staff continue to pay "contributions" (which would require a change in the constitution); raising the retirement age (not unreasonable, because Brazilians are living longer, healthier lives); indexing pensions to inflation rather than to the national minimum wage; and imposing a "taper" similar to that already in force for private-sector workers to discourage early retirement.

The deficit in the private-sector workers' retirement scheme is smaller but still needs to be reduced so that the government can redirect resources to Brazil's poorest. José Pastore, a labour-market economist, has put forward a novel solution: to cut workers' contributions instead of raising them, because current rates are so high that they cause widespread evasion. As things stand, employers and employees are each supposed to contribute 10% of salary to the scheme, and the self-employed are meant to pay 20%. Over the years, the burden of this and other payroll taxes has hugely boosted informal working, which now accounts for 54% of those in employment. In theory, no contributions, no pension; but once this generation of workers without entitlements gets old, the government will come under pressure to support them. Mr Pastore suggests offering workers a choice of contribution levels which will eventually provide pensions to match.

As well as fixing the federal finances, a rapid and effective pension reform could in the long term help to solve the dire financial problems of many states and municipalities. Mr Cardoso's government refinanced their debts "one last time" and then passed a fiscal-responsibility law, which among other important measures banned future bail-outs. Some powerful governors and mayors are now pressing Lula to go back on this ban, but that could open the floodgates.

### Making the money go further

Pensions are only one area where government spending is poorly targeted and Lula needs to make tough choices. Most places at the "free" (ie, taxpayer-financed) public universities go to youngsters whose parents have enough money to put them through private schools first, whereas students from poor homes, if they are lucky enough to complete their secondary education in the dismal state schools, have to pay to go to private universities. Well-paid

graduates should be made to repay a share of their tuition costs, freeing up money to improve primary and expand secondary education for the poor.

Some of Brazil's myriad payroll and turnover taxes go into an alphabet soup of training and business-advice agencies known as the "s-system". Trade unions and employers' associations also get their hands on all sorts of taxpayers' money, to spend on everything from apprenticeships to arts sponsorship. No doubt some of these "parastatals" (nominally independent but financed and regulated by the state) do some good, but few of them provide value for money. A UN official familiar with their workings graphically describes the better ones as "the occasional island of gold in a sea of shit". Soon after the election, Lula's team announced plans to review much of this spending, as part of a proposed reform of trade unions.

The list of poorly directed spending goes on and on. Mr Giannetti, the economist, says municipal council chambers, with all the special allowances councillors award themselves and their armies of hangers-on, cost 3.6 billion reais a year. The councillors are supposed to scrutinise the work of the elected mayors who run the cities, but they do a lousy job. The same could be said of state assemblies. And the federal banks offer cut-price housing loans to millions of middle-class borrowers who

could afford commercial loans, once again using resources that could be better spent on more needy citizens.

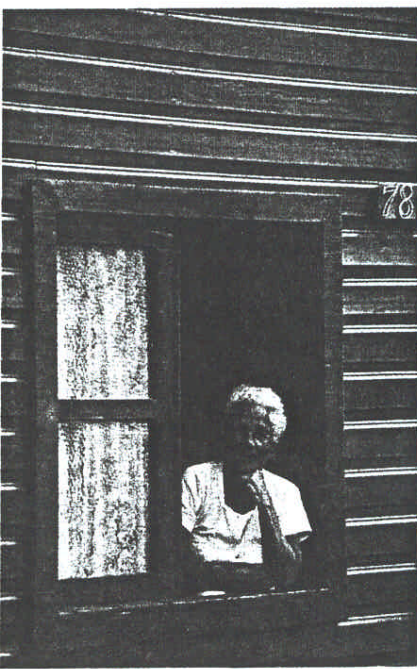
Last but not least, there is the considerable amount of public money stolen by corrupt politicians, officials and even judges. During the election campaign, Lula's advisers claimed that corruption was eating up 20-30% of public spending. That may have been an exaggeration, and many of the biggest scandals that emerged during Mr Cardoso's administration were old ones being uncovered at last. But tough action to stamp out corruption is one of Lula's most important challenges, not just because of the drain on the public purse but also because it undermines the rule of law and thus contributes to Brazil's appalling record of violent crime (of which more later). In local government, Lula's PT has a record of being less corrupt than most other parties, though it is not quite as saintly as it makes itself out to be.

### A taxing problem

When Mr Cardoso came to office in 1995, he promised to fix Brazil's messy, growth-inhibiting tax system. Firms had to pay various turnover taxes in "cascade", ie, they could not deduct the taxes they paid on their inputs from their output taxes, so as components passed down the production chain they attracted taxes on top of other taxes, making Brazilian products more expensive than imported equivalents or those assembled in Brazil from foreign parts. The heavy burden of payroll taxes, along with the restrictive labour laws, also discouraged firms from creating jobs.

Despite its early promises, Mr Cardoso's government was so fearful of losing revenue that it never pressed hard for tax reform. Indeed, to stave off financial collapse, it made the tax system even more burdensome by imposing new, supposedly temporary emergency taxes. Only in December did Congress, with a push from both the outgoing and incoming governments, at last approve the first stage of the reform, turning one of the less important cascade taxes into a value-added tax.

A thorough revision of the tax code is now needed to allow the economy to grow faster and create more jobs, while also increasing tax revenues and thus easing the government's financial problems. The current profusion of federal and local taxes could be replaced by a broad value-added sales tax, with the revenues shared among the different levels of government. The many income-tax allowances that the better-off enjoy could also be cut, reducing ►►



Who'll cover my pension deficit?

► the scope for evasion, which is currently widespread.

The trouble with tax reforms is that they tend to create big winners and big losers. The winners keep quiet and the losers, whether industries faced with bigger tax bills or governors and mayors faced with big revenue losses, scream the house down. Any worthwhile reform will mean changing the constitution, which means winning a broad consensus in Congress. Lula's best hope is to propose a long transition period so that the losers have time to adjust, and tax rates can be changed to correct any decline in total revenues.

Another move that could ease the government's financial problems and boost

economic growth is to grant independence to the Central Bank. Its new governor, Henrique Meirelles, formerly a boss at FleetBoston, an American bank, has raised this year's official inflation target by two percentage points to 8.5%, but has increased interest rates by half a point to show that he means to defend it. If he were given full autonomy to set monetary policy, the Central Bank would have greater credibility, and so might not have to keep interest rates at their current sky-high 25.5%. That would cut the financing costs of both the government and of business. Lula's economic team says pushing Central Bank independence through Congress is a top priority, though it faces opposition

from the PT's left wing.

Vociferous vested interests stand in the way of all these reforms, which is why Mr Cardoso was unable to get them through, even with a congressional majority supposedly bigger than the three-fifths needed to change the constitution. Lula, with a minority government, has a mountain to climb, and quickly, while his post-election momentum lasts. If he succeeds, he may be able to banish the spectre of financial collapse, and Brazil may start growing at the 5% a year he dreams of, rather than the meagre average of 2.3% that it managed in the past eight years. Among other things, that would make it easier for him to tackle poverty. ■

## Three square meals a day

Lula's "Zero Hunger" programme will not eliminate poverty on its own. But he won't be starting from scratch

**"IF, BY the end of my term, all Brazilians are able to eat breakfast, lunch and dinner, I will have fulfilled my life's mission,"** said Lula in his inaugural speech as his country's president on January 1st. "While there remains one Brazilian brother or Brazilian sister going hungry, we have more than enough reason to be covered in shame." To end this national disgrace, the flagship of his administration's all-out attack on poverty would be *Fome Zero* (Zero Hunger), a scheme to ensure that even the poorest Brazilian will get three square meals a day.

Having been born dirt-poor and known what it is like to go hungry, Lula is undoubtedly sincere in his pledge that he will do everything possible to put an end to the deep poverty that, by some measures, afflicts 50m of his compatriots. But criticism by many poverty experts—including some within his own party—has forced the president to reconsider his original version of *Fome Zero*. Inspired by America's Food Stamps programme, which President Roosevelt introduced in the Great Depression of the 1930s, this would have given poor people coupons to exchange for food in the shops. When critics said this would lead to widespread fraud and the development of a black market in coupons, as it did in America, Lula backtracked, but only partially. Recipients will now get cash, but they may have to prove they spent it on food—which, if enforced, will doubtless lead to a thriving in-

dustry in fake receipts.

So far, then, Lula's big idea is turning out not that different from the range of cash benefits for needy families introduced towards the end of Mr Cardoso's presidency. When he first took office, Mr Cardoso concentrated on cutting inflation (which in itself led to a big drop in poverty, because the poor had been least able to keep up with rising prices), cleaning up Brazil's financial system and privatising inefficient state firms. But in his last couple of years he oversaw the creation of a broad anti-poverty strategy which—for the first time in Brazil's history—aimed to allocate resources on the basis of need, as opposed to the vote-buying approach that had marked past social programmes.

Far from having to start from scratch, as

he has claimed, Lula has thus inherited a well-established set of welfare policies aimed at improving the health and education of Brazil's poorest communities and putting cash directly into the pockets of poor families. His best bet is to continue, expand and improve his predecessor's welfare strategy, rather than try to invent something new. Mr Neri, the poverty expert at the Getulio Vargas Foundation, says that despite some criticisms, Mr Cardoso's welfare policies were "a veritable revolution," and that Lula "must not throw all this away".

### Life at the back of beyond

A visit to Araiões, a small, abjectly poor town of 35,000 people in the hot north-eastern state of Maranhão, shows that the anti-poverty strategy Lula has inherited is already beginning to bear fruit. In 2001 Mr Cardoso created the Alvorada project to reduce poverty in areas with a low Human-Development Index (HDI). This is a measure of deprivation devised by the UN Development Programme (UNDP) that takes into account education and life expectancy as well as income. By this measure, in 2000 Brazil as a whole had an HDI of 0.76 on a scale of 0 to 1 (see chart 4), compared with 0.94 for Norway, the world's most developed country. Araiões was Brazil's fifth-poorest municipality, with an HDI of only 0.49, slightly better than Bangladesh's. Its infant-mortality rate was nearly treble the Brazilian average, and ►►

